

Tilburg University

Light is Right

de Bijl, P.W.J.; van Damme, E.E.C.; Larouche, P.

Publication date:
2005

Document Version
Publisher's PDF, also known as Version of record

[Link to publication in Tilburg University Research Portal](#)

Citation for published version (APA):
de Bijl, P. W. J., van Damme, E. E. C., & Larouche, P. (2005). *Light is Right: Competition and Access Regulation in an Open Postal Sector*. TNT and Deutsche Post.

General rights

Copyright and moral rights for the publications made accessible in the public portal are retained by the authors and/or other copyright owners and it is a condition of accessing publications that users recognise and abide by the legal requirements associated with these rights.

- Users may download and print one copy of any publication from the public portal for the purpose of private study or research.
- You may not further distribute the material or use it for any profit-making activity or commercial gain
- You may freely distribute the URL identifying the publication in the public portal

Take down policy

If you believe that this document breaches copyright please contact us providing details, and we will remove access to the work immediately and investigate your claim.

'Light is Right'. Conditions for **Competition** and Regulation in the Postal Market

BY DR. PAUL DE BIJL,
PROFESSOR DR. ERIC VAN DAMME
& PROFESSOR DR. PIERRE LAROUCHE

Tilburg Law and Economics Center (TILEC)

'Light is Right'.
Competition
and Access Regulation in an
Open Postal Sector¹

BY DR. PAUL DE BIJL,
PROFESSOR DR. ERIC VAN DAMME
& PROFESSOR DR. PIERRE LAROCHE

**Tilburg Law and Economics Center
(TILEC)**

June 2005

**TILEC – Tilburg Law and Economics Center
Warandelaan 2, P.O. Box 90153
NL-5000 LE Tilburg, The Netherlands
PHONE +31 13 466 87 89 FAX +31 13 466 80 47
EMAIL tilec@uvt.nl**

Executive Summary

The anticipated removal of remaining legal monopolies in the European postal market forces lawmakers and regulators to review the current regulatory framework thoroughly. More particularly, competitors of the incumbent will have the ability to provide end-to-end service to their customers, thereby opening new business opportunities. There is no need for regulation if a competitive postal sector – policed with competition law – ensures that public policy objectives are attained. This study argues this point while focussing on downstream access; it does not discuss any other regulatory measures (universal service, price regulation etc.).

Economics of the postal sector

There is consensus amongst economists that while some segments of the postal sector are characterized by considerable economies of scale, there are generally no natural barriers to entry in the form of monopolistic bottlenecks. In other words, each and every element of the incumbent's business can be duplicated.

Furthermore, the presence of multiple mail streams with different service requirements means that competitors have a number of potentially successful entry strategies to choose from. Entry can begin on a small scale, for instance by targeting certain target groups (large mailers), certain regions, etc. Different cost structures of new entrants can be expected due to the fact that a large proportion of the mail does not require the service levels defined as USO requirements in the past. Entry can also start from an existing base, a related business, so as to profit from economies of scope and thereby neutralising some of the economies of scale of incumbent postal operators. Accordingly, competitors do not have to set up collection, transport, sorting or delivery facilities – if at all – at the same scale as the incumbents in order to reach profitability quickly.

With the removal of the reserved sector, end-to-end competition becomes possible across the board. When faced with the alternative of losing mail flows entirely to competitors, incumbents have an incentive to offer services to their competitors in order to retain at least part of the revenue lost to them.

Country studies

An examination of the experience in Germany, the Netherlands, the United Kingdom and Sweden confirms the absence of any monopolistic bottleneck in the postal sector.

What is more, to the extent that end-to-end competition has been allowed over the whole or part of the sector, competitors have been able to launch profitable operations even on a small scale, without using the mandatory access system (if available) or without requiring one.

Consequences for the regulatory framework

A number of challenges arise in adapting regulation to an open environment. Regulation must move from a technical to an economic approach, where competition law becomes a key benchmark.

¹ The report was commissioned by Deutsche Post World Net and TNT.

Under EC competition law, using the conditions set out by the ECJ in *Bronner* and *IMS*, it appears highly unlikely that the essential facilities doctrine could be used to mandate access to the incumbent's network. To the extent it holds a dominant position, however, the incumbent could be subject to a non-discrimination obligation in its dealings with third parties.

There must be a strong justification for any regulatory framework to go beyond EC competition law. In particular, the "perfect competition trap" must be avoided: the shared objective of competition law and regulation is not to have a certain number of competitors on the market, but rather to have effective competition with a view to increased consumer welfare. Effective competition means value for service; effective competition is not incompatible with one operator holding a large share of the market, as the contestable market model shows.

In order to assess whether any regulation is necessary, the tests developed by the Commission in other sectors are relevant. Regulation can only come into question on a relevant market:

- with high and persistent barriers to entry;
- with no prospect of effective competition over time;
- where competition law alone does not suffice to address problems.

There is no obvious candidate market for regulation in the postal sector at this time. In any event, any regulatory remedy would have to respect the general principles of adequacy (the remedy addresses the problem) and proportionality. *Most importantly, lawmakers and regulators must avoid prescribing entry strategies and thus impeding dynamism and innovation.* If necessary at all, lighter remedies (such as a non-discrimination obligation, as opposed to access obligations with price control) must be investigated first.

Policy evaluation and recommendations

Amongst the countries studied here, the UK is pursuing a somewhat interventionist policy in which it can, if requested, impose access terms, with Postcomm preferring Royal Mail to develop an access code for access to its delivery network. In Germany the incumbent is obliged by law to offer downstream access services which terms and conditions are set by the National Regulatory Authority. The Netherlands and Sweden, in contrast, leave access issues to be settled via negotiations between operators. The performance of these latter markets – in the Dutch case even before its complete opening – shows that competitors are able to operate profitably without mandated access, and that the market even performs better without such access.

Accordingly, the regulatory framework for an open postal market must be thought through carefully. The lack of monopolistic bottlenecks (and thus the possibility of bypass) puts the incumbent in such a position that a light regulatory framework – if any – is likely to suffice, knowing that competition law will also apply. Possible distortion of the market by more interventionist models and the extra costs that are generated due to complex regulation make them less attractive. In the end, there is every reason to open up the sector with a very light regulatory framework.

Table of Contents

1. Introduction	5
2. Conceptual Issues.....	8
2.1 Entry Barriers.....	8
2.2 Natural Monopoly.....	10
2.3 Monopolistic Bottlenecks.....	12
2.4 Drawbacks of Access Regulation	13
2.5 Economies of Scale and Entry Strategies	14
3. Consequences for the Regulatory Framework.....	17
3.1 Challenges for Regulation	17
3.2 Main Elements to be Expected in the Regulatory Framework.....	19
3.3 Relationship between Market Players: the Starting Point under Competition Law	20
3.3.1 Market Definition.....	20
3.3.2 Market Assessment.....	21
3.3.3 Access to Facilities.....	22
3.3.4 Non-Discrimination	24
3.4 The Implications for Regulation.....	25
4. Country Studies	27
4.1 The German Market	27
4.1.1 Market Opening.....	27
4.1.2 Downstream Access.....	28
4.1.3 State of Competition on the Market	28
4.2 The Swedish Market	29
4.2.1 Market Opening.....	29
4.2.2 Access Regulation	29
4.2.3 State of Competition on the Market	29
4.3 The Dutch Market	30
4.3.1 Market Opening.....	30
4.3.2 Access Regulation	31
4.3.3 State of Competition on the Market	31
4.4 The United Kingdom Market	32
4.4.1 Market Opening.....	32
4.4.2 Access Regulation	32
4.4.3 State of Competition on the Market	34
5. Conclusions and Recommendations	36

1. Introduction

In its most recent progress report to the Council on the application of the Postal Directive², the European Commission writes:

"Broadly speaking, the postal market has continued to move towards a one-way distribution market and away from the more traditional two-way communications model. ... However, competition has yet to develop in the addressed mail segment outside niche services, and this suggests that limited initial market opening combined with sometimes limited regulatory capacity or certainty, advantages enjoyed by incumbents, and regulatory asymmetries have all combined to deter entry".

In its discussion on potential entry barriers, the Commission then elaborates on regulatory asymmetries, such as differences in VAT treatment between incumbent Universal Service Providers (USPs) and new entrants, the continuing protection of incumbents and costumers' reluctance to change suppliers, however, the Commission does not discuss regulatory uncertainty in detail, nor does it reach a definite conclusion:

"The reasons for the continuously slow progress towards greater competition in fully liberalised postal markets are puzzling and deserve further analysis".

In this study, which was performed at the request of Deutsche Post World Net and TNT, we provide some elements for such an analysis. Clearly, with the abolition of legal barriers to entry (the reserved sector) in postal markets, the possibilities for competition increase, and we investigate whether effective competition can develop on its own, or whether specific access regulation is necessary or desirable. Our focus here is on downstream access, that is, on inserting the mail at a point further down the value chain. Our conclusion is that specific access regulation, on top of generic non-discrimination principles, is not needed and may be counterproductive as it may force entrants into a specific entry mode, thereby possibly limiting innovation.

To put it differently, in this paper, we ask whether, in a liberalised postal market, besides legal and regulatory entry barriers, there are natural entry barriers, relating to the economics of the postal sector, which could prevent or delay profitable entry. We conclude that, as a result of the market moving to a one-way distribution market and the absence of monopolistic bottlenecks in the sector, a large section of the postal market will be accessible after full liberalisation, hence, there are no natural entry barriers. At the same time, regulatory uncertainty about the conditions under which access to the USPs delivery network will be available, may make entrants that wish to offer end-to-end services reluctant to invest in the rollout of their own operations, thus limiting the development of competition. As we argue in this paper, the absence of natural entry barriers implies that a hands-off approach, relying on

² Report from the Commission to the Council and the European Parliament on the application of the Postal Directive (Directive 97/67/EC as amended by Directive 2002/39/EC, Brussels, 23.03.2005, COM(2005) 102 final.

negotiated access rather than imposing regulated access, leaving the development of competition to the market, is most desirable.

The Postal Directive³ does not impose specific access rules, although it refers to transparent and non-discriminatory access to the postal network, to tariffs and special tariffs having to be "geared to cost", and to the USP having to take into account avoided cost when setting special tariffs. In the most recent progress report, in its interim conclusions on downstream access, the Commission states that access is an important issue that merits further analysis and that it appears premature to draw any conclusions at this stage. Elsewhere in that report, it is stated that:

"Access can help facilitate market entry for upstream consolidators. New competitors who want to establish a delivery network can also use access for a transitional period to build up customer relationships and volumes, before being able to compete end to end with the incumbent".

This no doubt is true, but it is only one side of the picture. If access is cheap as compared to rolling out alternative infrastructures, then facilitating access may hinder the development of full end-to-end competition, or it may prevent it altogether. As infrastructure competition typically offers more scope for innovation and provides stronger incentives for cost reduction, facilitating downstream access may thus be counterproductive. In this paper we argue that, taking into account EC competition law and using the principles underlying the most recent regulatory thinking – in particular the EC Electronic Communications Framework – one comes to the conclusion that access should not be regulated. Consequently, any access regulation would have to be justified by specific and pressing concerns and, since, as argued above, regulating access may decrease rather than increase economic welfare, certainly in the long run, an economic justification may be hard to find.

Our conclusion differs somewhat from that reached by NERA in its study on the economics of postal markets that was conducted on behalf of the Commission.⁴ In that study it is stated (with emphasis added):

"On the basis of our analysis in the previous section, but provided access to delivery networks is granted where necessary, we believe that the scope for competition in postal services is substantial".

We agree that the scope for competition is substantial, but in our view, given that delivery is not a monopolistic bottleneck, the incumbent will typically find it to be in its interest to provide access, especially when a non-discrimination requirement is in place. Consequently, obliging the USP to provide access at regulated terms may not be necessary. If it were nevertheless found that regulatory intervention could bring added value, we believe that the requirements of transparency and non-discrimination should be sufficient to establish a competitive postal market.

In the remainder of this paper we further substantiate the above argument, proceeding along the following lines. First, in Section 2, we discuss general theoretical arguments from economics, addressing the question whether there are natural barriers to entry. We argue that there is some confusion in the literature

³ Directive 97/67 of 15 December 1997 [1998] OJ L 15/14, as amended by Directive 2002/39 of 10 July 2002 [2002] OJ L 176/21.

⁴ NERA "Economics of Postal Services; A Report to the European Commission DG Markt", July 2004

about basic concepts, such as natural monopolies, monopolistic bottlenecks and entry barriers. We explain the differences and conclude that, on the basis of economic theory, there is no justification for regulatory intervention on access as there are no monopolistic bottlenecks in the sector, i.e. there are no elements in the production chain which are essential to provide the service and which cannot be duplicated by competitors. Note that the absence of entry barriers implies that potential entry may be a powerful force for disciplining incumbents, hence, even if entrants do not have a large market share, this should not be interpreted as the market not being effectively competitive. We conclude Section 2 by providing indicative calculations to show that profitable entry strategies exist in several market segments and that, already with a low market share, entry may be profitable. While it may be unlikely that entrants will compete on all market segments, entry is scaleable and entrants can access a relatively large portion of the mail market. Secondly, from the legal side, in Section 3, we apply the framework of thinking associated with the essential facility doctrine and the body of thinking that has evolved around the new electronic communications framework. The former specifies conditions under which intervention on the basis of the competition law would be justified, the latter provides a framework for addressing the question: is ex ante intervention desirable? We show that both lead to the conclusion that a hands-off approach is most desirable. In Section 4 we look at several European countries, specifically Germany, Sweden, The Netherlands and the UK, in more detail. In the final Section 5 we draw our conclusions and make several recommendations.

2. Conceptual Issues

2.1 Entry Barriers

In a recent NERA report on the postal market that was written on behalf of the Commission,⁵ the authors write:

“While there is no universally agreed definition of barriers to entry, they refer in general to disadvantages (such as higher costs, difficulties accessing key inputs, etc) that affect potential entrants but not incumbents, and that might prevent entry from occurring in cases where incumbent firms are earning excess (that is, super-normal) profits. In contrast, cost disadvantages that arise because incumbent firms are more efficient than potential entrants are not classed as barriers to entry. Barriers to entry may not prevent entry altogether, but may restrict it.”

This definition is in line with that given by DG Competition of the European Commission (2003)⁶:

“Barriers to entry are factors which prevent or impede companies from entering a specific market. Entry barriers may result for instance from a particular market structure (e.g. sunk cost industry, brand loyalty of consumers to existing products) or the behaviour of incumbent firms. It is important to add that governments can also be a source of entry barriers (e.g. through licensing requirements and other regulations).”

This definition links up with the usual distinction that is made in economics between “natural entry barriers”, “strategic entry barriers”, and “legal entry barriers”, where the latter category also includes regulatory barriers, such as regulatory uncertainty. As the objective of postal market liberalisation is to gradually remove the legal entry barriers, we will leave these out of our discussion. Strategic entry barriers, those resulting from the possible anti-competitive behaviour of the incumbent USP provider, can be tackled by competition policy, and will also not be discussed here. Our focus will, hence, be on natural entry barriers, that is, those that arise from the structural characteristics of the supply or the demand side of the market.

Unfortunately, as already hinted at in the NERA report, despite the importance of the topic, the economic literature on natural entry barriers is somewhat confusing and less developed than would be desirable. First of all, the literature provides a range of alternative, non-equivalent definitions.⁷ Secondly, an entry barrier might be high or

⁵ Supra, note 4

⁶ European Commission (2003), *Glossary of Terms used in Competition related matters*, http://europa.eu.int/comm/competition/general_info/glossary_en.html#top.

⁷ The most well-known are those of Bain (1965) (‘an advantage that incumbent providers in an industry have over potential entrants, that allows them to elevate their prices above the level that could be expected in a competitive market without inducing potential entrants to enter the industry’) and Stigler (1968) (‘a cost of producing ... which must be borne by a firm which seeks to enter an industry but is not borne by firms already in the industry.’) To the latter requirement, Gilbert (1989) adds that this cost advantage must result in excess profits (as opposed to the profit level in a competitive market) for the incumbent providers.

low, but the definitions do not make a distinction: an entry barrier might have large or small effects. Consequently, the key question for policy, whether an entry barrier is so high as to make access regulation desirable, cannot be answered on the basis of just the abstract definitions, the more so since these definitions do not look at alternatives and at the question what is the best way to do away with the limitations on competition that are caused by entry barriers.

Be that as it may, economists agree that sunk costs, costs associated with entry that cannot be recovered when the firm exits again, can be an important entry barrier. However, as stated in the NERA report that was referred to above, and also in TILEC (2003),⁸ the main features of the postal industry do not impose significant sunk costs: sunk costs are negligible for postal operations, which build on computerized pre-sorting and manual sequencing. Consequently, in the postal sector, sunk cost can be neglected as a potential source of barriers to entry.⁹

The picture is different with respect to scale economies, or economies of density, as they are called by NERA. We note that the different definitions have different implications as to whether scale economies are entry barriers: according to the Bain definition, they are, according to Stigler's definition, they are not. The NERA study shows that economies of scale are very important in the postal sector. As they write "The evidence from our econometric work is of economies of density. When traffic increases on a fixed postal network unit costs fall. In the original 15 Member States total costs would increase by 6.5 per cent if traffic on a fixed network were to increase by 10 per cent". Does this cost advantage constitute a barrier to entry? The answer is "no", if an entrant would have a superior technology, then it could make an offer to the large senders that would make all these senders better off and that would be profitable if it would be accepted by all these senders. In short, scale economies do not constitute an entry barrier; at least, scale economies *alone* do not constitute one. It would only be impossible for the entrant to enter if the business senders would be somewhat loyal to the incumbent, that is, if there simultaneously would be demand side inertia.

We have arrived at the same conclusion as the one that was obtained, more generally, in the recent academic literature. In a series of recent papers, in the *American Economic Review*,¹⁰ it has been pointed out that the unsatisfactory nature of the existing definitions arises from the fact that these are based on static models. As Carlton has written "The failure of the concept of barrier to entry to incorporate a time dimension means that it is a concept that is in need of additional embellishment in order to be useful in a practical problem or for antitrust or regulatory proceedings". In another one of these papers, McAfee et al conclude that scale economies *combined with brand loyalty* may produce an entry barrier. The intuition is as follows. Suppose that the incumbent and entrants can produce according to the same cost function with increasing returns to scale. If costumers move to the best offer immediately, entry is profitable. If, however, the costumers display brand

⁸ Paul de Bijl, Eric van Damme and Pierre Larouche "Towards a liberalised postal market", TILEC, Tilburg University, August 2003.

⁹ There are more than 1,000 license holders being active in the German market, testifying to the fact that there are no sunk cost (RegTP-data as of December 2004). Of course, for full-scale entry, of similar size to the USP, one needs to establish sorting centers, and this involves sunk cost.

¹⁰ American Economic Review, Papers and Proceedings 2004, with the following contributions: Preston McAfee, Hugo Mialon and Michael Williams: "What is a barrier to entry?", Dennis Carlton: "Why barriers to entry are barriers to understanding", Richard Schmalensee: "Sunk costs and antitrust barriers to entry".

loyalty towards the incumbent, then the entrant can build up market share only slowly, and revenues will be lower at the start. This need not be a problem if investments are scaleable and can be postponed to match with demand, however, if investments are lumpy and have to be incurred at the start of the operations, then it may take too long before profits are made. The result may then be that entry can become unprofitable.

The question thus is whether, in the postal sector, brand loyalty is so large, and investments so lumpy so as to induce an entry barrier in combination with scale economies. Direct evidence on this issue is scant, but we believe that experience with liberalization in other sectors clearly shows that large costumers quickly switch to better offers when these are available. Similarly, the postal sector clearly demonstrates that entry is scaleable. Consequently, in our opinion, scale economies do not either contribute to entry barriers. More precisely, in order to assess whether it is justified to compel network access, it is important to determine whether, in the postal sector, there are insurmountable entry barriers that interfere with normal market mechanisms, in particular the development of effective competition. *In our view, such insurmountable entry barriers, that would justify regulating access to the USPS networks, do not exist.*

2.2 Natural Monopoly

It is frequently stated that the postal market is a natural monopoly.¹¹ Although this statement may be true, it is misleading and hardly relevant, as we describe in this section. While the term “natural monopoly” is suggestive, the concept is associated with various misunderstandings. It is sometimes stated that:

- (i) an industry that is a natural monopoly is best served if there is only one supplier;
- (ii) in an industry that is a natural monopoly, competition is not possible (viable), hence, such an industry will naturally be a monopoly.

As we will show here, both statements are wrong in general. Before showing that, we provide an exact definition of the term and illustrate the limitations inherent in the concept.

For simplicity, consider a single product industry and let $C(\cdot)$ be the cost function of a (typical) firm in the industry. The industry is said to be a natural monopoly at output level Q if Q can be produced cheaply if there is just one firm in the industry, in other words, if the cost function is sub-additive at Q :

$$\text{If } \sum_{i=1}^{i=n} q_i = Q, \text{ then } C(Q) \leq \sum_{i=1}^n C(q_i)$$

¹¹ For a dissenting view, see Sean Ennis: “When is Postal Delivery a Natural Monopoly?”, paper presented at the 13th Conference on Postal and Delivery Economics, Antwerp, June 1-4, 2005.

The industry is said to be a natural monopoly if it is a natural monopoly at all possible output levels Q . We note that if unit cost are falling throughout, hence:

$C(Q)/Q$ is decreasing in Q ,

then the industry is a natural monopoly. In other words, if there are increasing returns to scale, then the industry is a natural monopoly.

One may immediately note the important implicit assumption underlying the concept that all firms are supposed to operate according to the same cost function. Now consider the first statement that an industry with such a cost function is best served by one firm. If the industry would be a monopoly, the single provider would, presumably, have market power. This would naturally lead to a higher mark-up, hence, a price that lies above marginal and average cost. If the monopolist is successful in raising price, then price may be higher than the price that would result under competition, even though in the latter case, the cost would be higher. In other words, lower cost need not translate into a lower price. Secondly, if the monopolist is shielded from competition, he need not have an incentive (or not an as strong incentive) to reduce costs. In other words, competition may lead to cost reductions that may not be available (or may not be as easily available) in the case of monopoly. To put it in yet different words, taking a dynamic perspective, competition may be preferable.

We wish to note here that regulation may limit the exercise of market power by the monopolist, hence, regulation may improve allocative efficiency, while maintaining (static) cost efficiency. In general, regulation will not be perfect, however. Even more importantly, regulation will probably not be as effective as competition in reducing cost.

Let us now turn to the second statement, that competition is not viable in industries that are natural monopolies. This statement is true if competition would take the form of price competition, *à la* Bertrand. This is the most intensive form of competition that can be imagined: it assumes that providers do not differentiate their products, that consumers are fully aware of the prices and that they switch to a cheaper provider no matter how small the discount that this provider offers as compared to the incumbent supplier. For other forms of competition that are less intense than Bertrand competition, entry is possible and can be profitable in markets that are natural monopolies. An example is provided by quantity competition *à la* Cournot. In this case, competition is less intense, the price cost margin is positive and entrants can profitably enter in monopolistic industries. *To conclude, in industries that are natural monopolies, competition may be feasible and competition may be preferable to monopolistic supply.*

2.3 Monopolistic Bottlenecks

A natural monopoly does not in itself necessarily present an insurmountable entry barrier. This is the most important insight that comes out of the 'contestability' literature (Baumol and Willig 1981).¹² If a company does not have to sink costs in order to enter the market, the threat of competition will impose discipline the incumbent: even if it has a high market share, the party will refrain from demanding non-competitive prices because of the risk of being undercut by a potential entrant.

In some industries, the network, or a certain segment of it, is of such a nature that, in order to be able to provide services to the costumers, access to this network is essential, and the network or the component involved cannot be reproduced. Examples would be the railways or the electricity industry, cases in which it would not be economically feasible to reproduce the physical network. Both of these cases involve a monopolistic bottleneck that a company must pass through if it wants to provide the respective services. In cases like these, an entrant must incur substantial sunk costs to enter the market, which may be prohibitive, and even if they are not, this provides a protective wall behind which the incumbent can hide.

The important distinction is, therefore, whether entering the market requires specific sunk investments. *The relevant question is not whether the industry is a natural monopoly, but rather whether there is a monopolistic bottleneck.* A company that owns a bottleneck facility (in legal language also called an essential facility) could be inclined to refuse competitors access to the facility in order to monopolise the market, and in such case *ex ante* regulation might be called for. As we argued above, in our view, there are no essential facilities in the postal sector.

Indeed, entrants are not faced with insurmountable entry barriers. It is possible to enter certain (product or geographical) segments of the market while incurring only low sunk costs and still attain a stable market position. From there, the entrant can eventually grow further (and still with only moderate sunk costs) and find a stable market position once it has reached a larger size, and so forth. In short, there is room for various entry and growth strategies, and as a consequence, one does not have to bring in a detailed set of regulations to help entrants get over a high entry barrier and, at the same time, drastically restrict the entrant's strategic choices or, at the very least, drastically curb the incentives to innovate. The absence of sunk costs allows entrants considerable flexibility in their organisation; this guarantees a high measure of allocative efficiency over time and promotes innovation. *The legal and regulatory framework should, therefore, be geared towards preventing a situation where various providers are tied to a fixed business structure.*

Without eliminating the possibility that only one provider will emerge to offer all services to all potential customers, it can be said with certainty that there are segments of the postal market that a newcomer can enter and turn a profit. This means that one should not only focus on full market entry, but especially pay attention to the segments of the market.

¹² William Baumol and Robert Willig: "Fixed costs, sunk costs, entry barriers and the sustainability of monopoly", Quarterly Journal of Economics (August 1981), 405- 431

2.4 Drawbacks of Access Regulation

Given the absence of monopolistic bottlenecks, the postal market allows for a variety of entry strategies. Entrants can, for instance, be categorized according to the entry mode (e.g. based on access or by investing in its own facilities) and targeted market segments (geographical and customer type). From telecommunications markets we know that regulation strongly affects the incentives on whether and how to enter the market (or a segment thereof). Moreover, entry decisions also depend on the expected future regulatory policy.

Given the heterogeneity among entrants, given the presence of universal service considerations and the great importance of the sector also as a source of employment, political motives and constraints may pose substantial problems while designing sound regulation. As certain entry modes depend, for their viability, on the regulatory framework, there is a 'demand' for certain regulatory interventions. The question is, however, whether regulators should try to aim at certain types of competition, or let the market determine what works best. Also, since the nature of universal service obligations affects entry and the resulting market structure, an assessment of the justification of universal service goals and means (based on a cost-benefit analysis) is called for.

It is important to note that entrants face regulatory uncertainty when deciding whether or not to invest. For instance, they may act more cautiously, to wait and see which regulation will apply in the liberalized segments. This results in a delay of entry and investments, slowing down the maturing of competition: entrants choose a smaller coverage, or invest less in their own facilities, than without regulatory uncertainty. For instance, some segments mature faster than others, and entrants may plan to target some segments earlier than others. If investments are delayed in a particular segment, entry can also be delayed in other segments, in particular if entrants become active in a stepwise manner: entering the next segment only if entry in the previous one was successful. Hence, as a result of regulatory uncertainty, overall entry will be delayed and the strong position of incumbents will be maintained longer than necessary, increasing the need for heavy-handed regulation. Also, regulatory uncertainty creates a bias towards entry modes based on access, and away from investments in their own facilities. In this respect, it would be best to settle the access issue once and for all.

In order to make access operational, both the incumbent and the entrant have to adapt their internal organization and processes. The incumbent has to create 'space' for the incoming mail volumes, both physically and with respect to capacity and planning. The entrant has to set up its processes such that they are in line with the incumbent's requirements for incoming mail volumes. The investments that the firms have to do to make this possible, are specific for this activity only. This creates a mutual dependency among the firms. In the case of unforeseen events, such as an 'external event' causing a hiccup in the incumbent's sorting/delivery system or a failure by the entrant to deliver the agreed volume, the firms (or at least one of the involved parties) will try to renegotiate the charges and conditions of the access agreement. Given that their interests are not aligned, this will not be easy and will involve substantial transaction costs, for instance because the regulator, or perhaps a court, will have to intervene. Also, given that contracts will always be incomplete,

one can expect that these types of problems will arise sooner or later.¹³ An entrant that does not rely on access but invests in its own facilities will be facing a higher investment 'hurdle', but it benefits by not having to make asset-specific investments of the type needed in the case of access-based entry. Consequently, such an entrant will not be subject to a 'hold-up' problem and costly problems of renegotiation will be avoided when entrants do not rely on access. As the literature shows, in the case of complementary assets, investment and innovation is spurred by vertical integration, hence, stimulating end-to-end competition may yield dynamic benefits. Policy makers would be well advised to take the costs and inefficiencies caused by incomplete contracts and renegotiations into account when designing regulatory interventions.

It seems to us that, up to now, the two issues discussed in this subsection, regulatory uncertainty and incomplete contracting, might not yet have received the attention they deserve, and that due consideration of these issues may well reverse the preference from access based competition to end-to-end competition. In any case, this point strengthens our argument for a light-handed approach to intervention.

2.5 Economies of Scale and Entry Strategies

Given scale economies in delivery, new entrants to postal markets need to have efficiency advantages, or other cost advantages, in order to compete successfully with incumbents. After all, if they would have the same cost function, then with a smaller market share, they would automatically have higher unit cost. The natural question now is how large a market share a "reasonably efficient" entrant needs to obtain in order to reach cost parity with the incumbent. Obviously, the answer to this question will depend on the precise details of the market under consideration, on the cost structure and the efficiency of the incumbent, on the wage premiums that it pays, etc. Consequently, providing an answer is beyond the scope of this paper. Nevertheless, in this section, we provide a perspective by briefly discussing some papers that have addressed this question. We believe this discussion to be warranted as these papers have come up with widely varying estimates of the critical market share. Clearly then, more research on this topic would be welcome.

It is obvious that entrants will not choose to mimic the business models and networks of incumbents. These originate from a time when the postal market was very different and they have been designed to fulfil the universal service obligation that is imposed on the incumbent. Entrants do not face such restrictions, and they will take advantage of the current situation. The postal market has moved away from a traditional two-way communications market, with businesses now being responsible for 80 to 90% of the mail that is offered. Single item residential mail is only a small segment of the market and as handling of it is costly, this segment is less attractive to entrants. Entrants will predominantly focus on the B2B and B2C segments, both on high value mail as well as on bulk mail. Here we restrict ourselves to the latter. Entrants' ability to compete in that segment is enhanced by the fact that the market is relatively concentrated on the sender side. In the Netherlands, for example, 50% of the mail originates from 500 to 600 large senders.¹⁴ In addition

¹³ For an overview, see Hart, O. (1995), *Firms, Contracts and Financial Structure*, Oxford: Oxford University Press.

¹⁴ IG&H Management Consultants (2003) "Marktontwikkelingen en praktijkcases tonen toegankelijkheid van de Nederlandse postmarkt aan", Woerden, June 2003.

such mail can be pre-sorted electronically, hence, the entrant just has to focus on sequence sorting and actual delivery. As long as the entrant serves a limited number of customers, the first task can easily be done manually, which implies the absence of costly investments. Consequently, entrants can keep things simple and cheap by targeting a few large senders that generate sufficient volume. Indeed, several successful entrants in European postal markets, such as CityMail in Sweden and Sandd and Selektmail in the Netherlands, seem to adopt models of this type.

Taking such a model as our basis, the question is what volume an entrant needs in order to reach cost parity with the incumbent in delivery. As described above, the entrant has a less complex mail flow, hence, it will incur lower sequence sorting costs than a (traditional) incumbent that manually sequences the mail. Consequently, we may focus on actual delivery. Obviously, given economies of scale, the entrant would like to limit the frequency of delivery as well as to restrict operations as much as possible to low cost, high density areas. In areas where the entrant's volume is thin, it will prefer to hand the mail to the incumbent for delivery. If the entrant's unit cost is lower than the incumbent's price, the entrant will choose to deliver itself.

Cohen and Chu¹⁵ were the first to calculate what market share a competitor would need to capture in order to have the same unit cost as the US Postal Service. Their calculation is based on a cost function that is estimated on detailed data from the US Postal Services. The cost function distinguishes between route time (a fixed cost representing the time it takes to complete the route), access time (the time it takes to visit an address along the route to make an actual delivery) and load time (the time it takes to place the mail in a mail receptacle); the first component is fixed, the second partly fixed and partly variable, and the third is 100 percent variable with volume. Cohen and Chu conclude that it is very difficult to enter the US market: an entrant that has a cost advantage of 50% and that delivers only one day a week would still need 15% market share in order to reach cost parity with the US Postal Service. An entrant that delivers two days a week would need 19% market share if it had a 50% cost advantage, and 23% if it had a 33% cost advantage. Clearly in the US, the critical market share is high.

A similar conclusion seems to be drawn by Postcomm for the UK. In Annex 1 to the Competitive Market Review,¹⁶ Postcomm reports results from a model that has been developed by Royal Mail. The conclusion drawn is that significant volume may be required to compete profitably head to head with Royal Mail: "to match Royal Mail's present unit cost for delivery six days per week, and depending on the assumptions about new entrant's costs compared to Royal Mail, a new entrant might need to capture around 50% market share". As Chart A1.1 in that Annex shows, an entrant that delivers only one day per week, would still need about 30% market share to reach cost parity, a surprisingly high number.

In contrast, several studies have come up with low critical market shares for the Netherlands. Using the methodology from Cohen and Chu (1997), SEO (2003) concludes that an entrant to the Dutch market would only need 10% of the volume

¹⁵ Robert Cohen and Edward Chu (1997) "A measure of scale economies for postal systems", in Michael Crew and Paul Kleindorfer "Managing change in the postal delivery industries", Kluwer Academic Publishers.

¹⁶ Postcomm "Competitive Market Review", September 2004.

to be able to compete with TNT on the basis of six days delivery.¹⁷ Even more relevant, that study concludes that an entrant that chooses to deliver 2 days per week only need 3% of the volume. An appendix to SEO (2003) contains a separate analysis by the economic consultancy firm Nolan, Norton & Co. This analysis also makes use of the Cohen and Chu (1997) methodology, but it complements it with data obtained from market parties. In addition, it discusses several alternative entry strategies.

The first alternative is entry by a greenfield operator, which has labour costs that are 60% of those of TNT. The conclusion is that, if delivery is limited to 2 days per week, 4% market share suffices to reach cost parity with TNT.¹⁸ Furthermore, the entrant would be very profitable if it would attract its business with a 10% discount as compared to the prices charged by TNT. A second scenario considers the case where the entrant already operates on related markets and hence can profit from economies of scope. In this case, entry (at existing prices minus 10%) would be profitable already with 1% market share, while cost parity would be obtained with 2% market share.

The conclusion is that the various estimates for the critical market share vary widely. This no doubt is partly due to the differences in the countries that are considered, the different methodologies that are employed, and the quality of the data. Given this variability, it is important to complement these analyses on the basis of models with actual experiences. In the Netherlands, two entrants, Sandd and SelektMail, each had about 2,5% of the market in 2004 and each of them claims to make a profit. In Germany, PIN-AG is an entrant that focuses mainly on the Berlin area. It started operations in 1999 and claims to have reached profitability in 2003. Meanwhile, it has achieved around 20% of the local Berlin market. In Sweden, City Mail has been active since 1991, focusing mainly on delivery of pre-sorted bulk mail in urban areas. Jonsson and Selander (2005)¹⁹ report that CityMail has 7,5% of the overall market and that it has 25% of the market segment in which it is active. Also this company appears to run a profitable business. *Apparently, entrants in several countries can compete successfully even with relatively low market shares.*

¹⁷ SEO (2003). Tante Pos krijgt concurrentie; effecten van de liberalisering van de postmarkt, SEO, Amsterdam, September 2003 at p. 29

¹⁸ A similar calculation is reported in TILEC: "Towards a liberalised postal market", Tilburg University, August 2003, but there the critical number is 14%.

¹⁹ Per Jonsson and Sten Selander: "The "real" graveyard spiral; experiences from the liberalized Swedish postal market". Paper presented at the 13th Conference on Postal and Delivery Economics, Antwerp, Belgium, June 1-4, 2005.

3. Consequences for the Regulatory Framework

3.1 Challenges for Regulation

The anticipated opening of the postal sector not only entails a revised economic analysis, but it also confronts regulation with a number of challenges.

As long as there is a reserved sector (as is the case now), postal regulation will follow a relatively predictable path. It will deal with:

- the delineation of the reserved sector;²⁰
- the management of the reserved sector, i.e. the type of services to be offered,²¹ the price thereof,²² accounting systems,²³ etc.;
- the interface between the reserved and the non-reserved sector.²⁴

The reserved sector plays a central role. Since it is under legal monopoly, it needs to be policed by regulation. Furthermore, the presence of a legal monopoly distorts the normal functioning of the market, so that there is less room for full-fledged economic analysis as a basis for sound regulation. Regulation can remain very prescriptive and technical.

In a liberalized environment, however, the reserved sector vanishes, and with it the need for detailed regulation to delineate and manage it. The whole postal sector is then open to the workings of the market economy. It is then imperative for regulation to rest on solid economic analysis in order not to cancel the benefits of the operation of the market. Overly technical regulation must be discarded in favour of regulation based on economics. Under these circumstances, detailed prescriptions at the legislative level are likely to make room for more general legislation articulated around economic analysis. Against that background, competition law – which is formulated in general terms and implemented by a competition authority – appears as a model. At the same time, it is also a benchmark: economic regulation which follows the footsteps of competition law in substance is likely to be justifiable, whereas regulation exceeding the bounds of competition law should require a specific justification.

More than anything else, the opening up of the postal sector means that the lawmakers and regulatory authorities must go back to the drawing board and rethink regulation thoroughly. Of course, the experience made in other comparable sectors – especially electronic communications – is highly relevant: there is no need to re-invent the wheel. However, that experience must be used correctly. Simply transposing the end-result of the regulatory process from one sector to the other is neither convincing nor responsible from an academic perspective. Rather, the main lesson to be drawn from the new framework in electronic communications lies in the

²⁰ Directive 97/67, Art. 7-8.

²¹ Directive 97/67 only provides for the universal service, Art. 3-6, and does not specify any other services to be offered within the reserved sector.

²² Here as well, Directive 97/67 only does so for the universal service, Art. 12-13.

²³ Ibid., Art. 14.

²⁴ Ibid., Art. 11 (this provision has not been used so far) and 12, 5th indent (by extension).

significance of a principled approach to regulation, which starts from the fundamentals. A lot of progress has been made on how to assess whether regulation is necessary, how to analyse markets, how to choose the appropriate remedy, etc. Therein lies the biggest contribution of other industries to the discussion in the postal sector.

Indeed the specific characteristics of the postal sector, as outlined above, present regulation with a further challenge. In sectors such as energy or fixed communications, the number of possible entry strategies is limited, and given the considerable sunk costs involved, it is legitimate for regulation to be designed in such a way as favour a given entry model (if a choice needs to be made). Even then, this is risky, since regulators may find it hard to withdraw access regulation later on, or commit to sunset clauses. Moreover, regulators and policy makers often fail to “foresee” what types of competition will or can develop. Hence, even in the presence of significant sunk costs, as in energy or fixed telecommunications, regulators should make utmost care to make sure that they do not distort entrants’ choices for different entry strategies.

Because of its different cost structure (no or less sunk costs), the above reasoning is even more important in post. In the postal sector, a number of different entry strategies are possible in an open postal market. *In the absence of any overriding reason, regulation should hence avoid prescribing how competitors are to enter the market by pushing them towards one strategy more than the other.* The need to refrain from pre-determining market outcomes becomes all the more urgent when a dynamic perspective is added. The availability of different entry strategies translates into uncertainty as to market developments over time. The operation of market forces then gains extra significance, since it is a prime vehicle to allow experimentation between those strategies with a view to improving consumer welfare. From a dynamic perspective, there are many reasons to preserve the full range of entry strategies:

- No one, including the regulatory authority, is able to predict which entry strategy will be successful, i.e. that it will meet demand requirements, either as regards price or non-price parameters, and improve consumer welfare. Given that unpredictability, it is preferable to allow market dynamics to do their work, offering customers innovative services and leaving customers to pick the winning strategies;
- Exposing the incumbent to a variety of entry strategies by its competitors forces it to remain itself nimble and innovative, and reduces the risk that the incumbent could fend off competition with a simple counter-strategy;
- Newcomers to the market compete also via their entry strategies. Depriving them of such an important competitive parameter could significantly dull their incentive to innovate in seeking the strategy which is best for each of them, turning the newcomers into clones of each other.

3.2 Main Elements to be Expected in the Regulatory Framework

The regulatory framework for an open postal sector is likely to deal with the following issues:

- access to the market, the objective being to make it as easy as possible;
- relationships between market players;
- relationships with consumers, the main issues here being the provision of universal service, protection of consumers against market power and other forms of consumer protection (information, etc.);
- procedural and institutional matters.

The overall objectives of the regulatory framework are likely to be the same as in electronic communications, namely:²⁵

- the promotion of competition;
- the development of the internal market; and
- the promotion of the interests of citizens (including universal service).

In comparison with the current framework, the objectives would be better outlined and hence their interaction easier to articulate. Now, the concept of “reserved sector” plays a central role, but it aims both at ensuring the provision of universal service and at delineating the room for competition and the internal market to be realized. This cannot but create confusion. In an open sector with these three objectives, on the other hand, it is logical to begin by re-thinking regulation in order to achieve the first two objectives (competition, internal market), and then to move on to universal service. The discussion of universal service starts with (i) a determination of what should be included therein (scope of universal service), followed by (ii) an assessment of whether the market delivers that universal service and (iii) if not, how its provision could be regulated (assignment of obligation, monitoring, financing) in such a way as to achieve universal service without compromising the other objectives.²⁶ Indeed if markets work and deliver universal service, then the need for regulatory intervention to ensure the provision of universal service is alleviated.

The recent proposals made by Postcomm for the regulation of Royal Mail (RM) after liberalization,²⁷ for instance, seem to approach the issue backwards. Postcomm takes as a starting point the need to allow the USP, RM, to have sufficient revenues to finance its universal service obligation, and then it proceeds to design a regulatory scheme which allows as much competition as possible, in Postcomm’s view. This means that Postcomm’s regulatory proposals aim not only to open markets, but also to provide a measure of protection for RM, typically by ensuring that RM receives a sufficient volume of mail to sustain its operations under a universal service constraint.²⁸ This latter aim is achieved by extending regulation further into the access products which RM offers to its competitors and large customers, introducing

²⁵ Directive 2002/21 of 7 March 2002 (Framework Directive) [2002] OJ L 108/33, Art. 8(2) to 8(4).

²⁶ See the approach followed in Directive 2002/22 of 7 March 2002 (Universal Service Directive) [2002] OJ L 108/51, Art. 3-15.

²⁷ Postcomm, *2006 Royal Mail Price and Service Quality Review – Initial Proposals* (1 June 2005), available on Postcomm’s website (visited on 7 June 2005).

²⁸ Indeed it is one of Postcomm’s duties to ensure that RM has sufficient revenues to finance its universal service obligations: see *ibid.*, para. S.26, S.33, 4.33.

a retail-minus price control regime over a basket of access offerings. This in turn encourages competitors to make use of RM's delivery facilities instead of rolling out their infrastructure, even when that would be more efficient. In the end, the aim of ensuring the financing of RM's obligations can conflict with the aim of opening markets to competition, leading to flawed regulation. It would have been preferable first to assess which regulatory framework would be necessary to ensure that open markets function effectively (as we argue in this paper, a light framework, if any, is sufficient), and only thereafter to ascertain whether universal service obligations can be discharged within such an environment.

The focus of the present research is on relationships between market players, and accordingly other parts of the regulatory framework will not be dealt with further.

3.3 Relationship between Market Players: the Starting Point under Competition Law

As was mentioned above, in an open postal sector, regulation is likely to be modelled on competition law. It is accordingly necessary first to examine what the situation would be under competition law in order to have a framework of reference for regulatory developments. We will look first at market definition, then market analysis and finally at the consequences under competition law of these findings.

3.3.1 Market Definition

As for market definition, there is no clear picture emerging yet from EC competition law. The decision practice at the retail level is starting to show some consistency, and much like in the telecommunications and air transport sectors, the Commission is breaking down the sector along certain characteristics and then combining these characteristics to define what are often relatively narrow markets. For instance, in *Deutsche Post/DHL*, a first-phase merger control decision, the Commission split the sector using the following characteristics:²⁹

- mail and parcel delivery on the one hand, and freight on the other hand,
- express and deferred services;
- domestic and international services;
- business and private customers.

This led the Commission to define markets such as "international express delivery", "international express freight" and "international business mail". It must be underlined, however, that ultimately market definition did not matter in that decision – even on the narrowest market definition there was no concern – so that it is still very much conceivable that the Commission would define markets differently in a case where the market definition mattered for the outcome.

Market definition at the level of services provided between competitors, in comparison, has not been developed that far:

²⁹ Decision of 21 October 2002, *Deutsche Post/DHL*, available on the DG COMP website (visited 20 May 2005), para. 10-18.

- Until now, the presence of legal monopolies influences market definition: that part of the postal service chain which is still under monopoly tends to be put in a relevant market and the rest on a second, separate market. Hence the Commission has tended to find a first market ranging from collection to the point in the service chain at the border between the reserved and open sectors, and a second market from that point onwards to delivery to the customer.³⁰
- It is too early to predict whether this approach – defining only two markets – will be continued in the context of an open postal sector, given that the Commission has a general tendency to define relevant markets narrowly.

In the end, it is probably safe to assume that there will be some relevant market for “downstream” services, but it cannot be forecast at which point in the postal service chain this market will start.

3.3.2 Market Assessment

In the absence of a clear view as to how market definition could turn out, it is difficult to predict the outcome at the market analysis stage (including the assessment of dominance). Indeed, given the findings made in part 2.3. about the lack of monopolistic bottlenecks, a good argument can be made that any large market position which could lead to a finding of market power – determined on the basis of historic market shares, size and resources of the firm, economies of scale, etc. – is vulnerable to entry and can quickly shrink.³¹ In that case, in the absence of a significant barrier to entry, potential competition would hold any market power in check and there would be no dominance.

For the remainder, it will be assumed for the sake of argument that the Commission, another competition authority or a court would nevertheless find that the incumbent postal operator holds a dominant position on a downstream market. The interesting issue is what consequences this would bring for the incumbent postal operator, i.e. which obligations would that imply. In other words, which type of behaviour could possibly constitute abuse according to the case-law, so that the incumbent should in practice avoid engaging in it?

Two types of obligation come into question here: access to facilities and non-discrimination.

³⁰ Two recent cases illustrate that point. In the recent *BdKEP* decision (Decision of 20 October 2004, available on the DG COMP website (visited 20 May 2005), para. 45-51.), dealing with domestic mail, the Commission found an upstream and a downstream markets. As regards cross-border mail, the Commission in *REIMS II renotification* (Decision 2004/139 of 23 October 2003 [2004] OJ L 56/76, para. 70-77.) distinguished between “outgoing cross-border mail” and “incoming cross-border mail”.

³¹ For a recent, accurate and authoritative summary, see the Commission Guidelines on market analysis and the assessment of significant market power under the Community regulatory framework for electronic communications networks and services [2002] OJ C 165/6 at para. 75-80.

3.3.3 Access to Facilities

Forcing firms to give access to their facilities to third parties (in the absence of previous dealings) brings competition law to its edge. It puts competition law on a collision course with another central value in the legal system, namely the protection of ownership (whether it concerns physical or intellectual property). The owner of property must be entitled to use and dispose of it. In an investment context, in particular, this principle gains a further dimension: the investor commits large sums of money to creating intellectual property or deploying facilities, and it should be entitled to make a return on that investment. This tension between competition law and property rights explains why the US Supreme Court³² and the ECJ³³ have traditionally been very reluctant to allow competition law to be used to open up access to facilities which were heretofore closed to third parties.³⁴

This is sometimes brought under the keyword “essential facilities”, but what matters is the test put forward in the case-law of the ECJ. In the case of physical facilities, the current test results from combining *Bronner* with *IMS*.³⁵ This test applies in order to judge whether a firm should be ordered to open up a facility (seen as a separate relevant market) in order to enable a competitor to compete with the firm on a secondary market. Before competition law can be invoked to force the opening of production facilities, four conditions must all be met:

- a) the facility is indispensable to operate on the secondary market, i.e. it cannot be duplicated;
- b) the refusal to give access to the facility is unjustified;
- c) the refusal to give access prevents the emergence of a new product for which there is customer demand;
- d) the refusal to give access is likely to exclude competition on the secondary market.

These four conditions will be reviewed in turn.

Indispensability of the facility

This condition was discussed at length in *Bronner*. That case is especially interesting since it is not only relevant as a legal precedent, but also on its facts. In *Bronner*, a small newspaper publisher in Austria (Bronner) wanted access (against reasonable remuneration) to the nationwide home delivery system of the largest newspaper publisher (Mediaprint), arguing that its own delivery method (using the Austrian post) was not competitive, and that it could not on its own (given its small circulation) create a parallel delivery system. The ECJ was asked by an Austrian court

³² See *Verizon Communications v. Trinko*, Docket 02-262 (13 January 2004).

³³ See the two most recent precedents (on which the discussion is based): ECJ, 26 November 1998, Case C-7/97, *Bronner* [1998] ECR I-7791 and ECJ, 29 April 2004, Case C-418/01, *IMS Health*, not yet reported.

³⁴ The Commission has traditionally been less reluctant than the ECJ to use competition law to open access to facilities. However, the ECJ has the last word. It will be interesting to see how the CFI (and perhaps eventually the ECJ) will assess the Commission's Decision of 24 March 2004, *Microsoft*, available on DG COMP's website, now before the CFI.

³⁵ The indispensability condition is not dealt with as a separate condition in *IMS*, since the case deals with intellectual property, which is by definition not duplicable (or only within narrow limits in the case of copyright) and thus indispensable. It is covered at length in *Bronner*, which deals with physical property. For the rest, the tests put forward in the two cases are similar, with *IMS* precisising that the conditions are cumulative.

whether Mediaprint's refusal to grant Bronner access constituted an abuse of dominant position within the meaning of Article 82 EC. The ECJ started by recalling that the first step is market definition: there might be existing substitutes to Mediaprint's system, thus making the relevant market larger and possibly leading to the conclusion that Mediaprint is not dominant.³⁶ Next, on the issue of indispensability, the ECJ adds that even if the relevant market were made up by Mediaprint's system alone, that does not suffice to make Mediaprint's nationwide system indispensable.³⁷ The ECJ notes that (i) there are other methods of delivery available (post, etc.) even if they are less advantageous³⁸ and (ii) competitors of Mediaprint can always, alone or in cooperation, set up a rival nationwide newspaper delivery system.³⁹ Very importantly, the ECJ adds that

"it is not enough to argue that [creating a rival system] is not economically viable by reason of the small circulation of the daily newspaper or newspapers to be distributed... [I]t would be necessary at the very least to establish...that it is not economically viable to create a second [system] with a circulation comparable to that of... the existing scheme. "

In the case of the postal sector, it is generally agreed that there are no monopolistic bottlenecks in the delivery chain. In other words, competitors can create a rival delivery system and bypass that of the incumbent, and some of them are already doing so. In line with *Bronner*, the fact that the competing systems are not or would not be identical to the incumbent's – whether in terms of coverage or frequency – does not turn the incumbent's delivery system into an essential facility. Finally, on the basis of *Bronner*, a competitor would have to show that, even with a volume of business comparable to the incumbent, it would not be "economically viable" to put together a competing postal delivery system. As was seen before in part 2.4, even with a volume of business substantially smaller than the incumbent's, competitors can already enter the market profitably on the basis of their own facilities. Accordingly, on the basis of the test in *Bronner*, the postal service chain would not comprise indispensable facilities.

Justification for the refusal

There is no specific information concerning this condition.

New product

In *IMS Health*, this condition was elaborated upon by the ECJ. In order to obtain access under competition law, the competitor must show that it "does not intend to limit itself essentially to duplicating the goods or services already offered on the secondary market by the [incumbent], but intends to produce new goods or services not offered by the [incumbent] and for which there is a potential consumer demand".⁴⁰ According to *IMS Health*, competitors cannot override the incumbent's property rights just to produce cheaper clones of the incumbent's services, they must indicate that they meet pent-up demand for innovative services.

³⁶ *Bronner*, *supra*, note 33, para. 34.

³⁷ *Ibid.*, para. 42.

³⁸ *Ibid.*, para. 43.

³⁹ *Ibid.*, para. 44.

⁴⁰ *IMS Health*, *supra*, note 33, para. 49, replacing "owner of the intellectual property right" with "incumbent" to match the situation in a case of access to physical property.

Elimination of competition on secondary market

This touches upon a central point. In sectors such as electronic communications or energy, entrants have a limited number of entry strategies, sometimes only one. In some cases, these strategies require access to the incumbent's facilities. In the postal sector, it was seen before in part 2 that entry on the postal market is scalable while there are no sunk costs, i.e. that there are many entry strategies which can succeed. Given the absence of monopolistic bottlenecks, these entry strategies do not depend on mandated or regulated access to the incumbent's infrastructure. Accordingly, there can be competition on the secondary market in any event. A competitor requesting access to the incumbent facilities would thus not be invoking competition law in order to have a chance at all to enter the secondary market; rather, it would be trying to use competition law to enforce a specific entry strategy despite the existence of a range of other available strategies. Put in the balance against the policy considerations mentioned above – respect for property rights of the owner of the facilities, this would go beyond the role of competition law. *Conclusion. On the basis of Bronner and IMS Health, there would be no case for using competition law (Article 82 EC) to force an incumbent postal operator to open access to its delivery facilities to its competitors.*

3.3.4 Non-Discrimination

On the assumption that a dominant position has been found, the holder of that dominant position is typically bound by an obligation of non-discrimination, i.e. discriminatory treatment is likely to constitute an abuse. Non-discrimination implies first of all that the dominant firm treats all third parties on the same footing, i.e. by offering similar terms and conditions.⁴¹ Only objectively justifiable differences in treatment are accepted, for instance rebates directly related to the volume of business. In a context of vertical integration, the Commission has taken a further step and claimed that "in general terms, the dominant company's duty is to provide access in such a way that the goods and services offered to downstream companies are available on terms no less favourable than those given to other parties, including its own corresponding downstream operations".⁴² To this day, the ECJ has not expressly endorsed the Commission's view. This latter extension of the non-discrimination principle is difficult to apply, and in any event it should not be used as a backdoor to impose access obligations which cannot be imposed under cases such as *Bronner* and *IMS Health*, as discussed above.

An interesting feature of the postal sector in this respect is that part of the work involved in providing a postal service can also be done by the sender itself. Typically, large clients can carry out some of the sorting operations themselves when producing the mail items and then deliver the mail to the incumbent at some further point down the processing and transport chain. In return for doing part of the work, these clients obtain various rebates. The obligation not to discriminate under Article 82 EC implies that, in an open sector, the rebates and other special conditions

⁴¹ See Larouche (2000) at 218-230, relying on leading case-law, including CFI, 6 October 1994, Case T-83/91, *Tetra Pak II* [1994] ECR II-755, confirmed by the ECJ, 14 November 1996, Case C-333/94 P, *Tetra Pak II* [1996] ECR I-5951.

⁴² Commission Notice on access agreements in the telecommunications sector [1998] OJ C 265/2, para. 86. Here the main examples are to be found in telecommunications decisions.

available to large clients should be available to competitors as well when they accomplish the same work and deliver mail in similar quantities.⁴³

3.4 The Implications for Regulation

In a fully open postal sector, regulation cannot rely on a technical basis any longer; rather it must be firmly grounded in economic analysis, as set out earlier. Competition law then becomes a benchmark for sector-specific regulation: in this respect, the conceptual and analytical principles of the new regulatory framework for electronic communications are very relevant.⁴⁴ Sector-specific regulation is designed against the backdrop of competition law and is meant to be aligned with competition law in substance. This means, among others, using economic analysis and following the well-known steps of market definition, market analysis and remedies.

It will be recalled that competition law is always applicable. Accordingly, as long as regulation sustains and strengthens the thrust of competition law without increasing the regulatory burden inefficiently, it plays a helpful role and can be justified. Regulation going beyond the realm of what can be envisaged under competition law, however, requires a strong justification.

A common failure is for lawmakers and regulators to fall into the “perfect competition trap” and indulge into micro-management of a sector. The temptation is strong to use regulation to try to pursue the idealized model of perfect competition, i.e. a market with a large number of firms of relatively similar and modest size. Yet the aim of competition law and regulation is to reach effective competition, meaning that competition induces the market to behave efficiently and to increase consumer welfare. Competition can take many forms, and what matters is not so much the structure of the market as the results it delivers. When a market is fully opened to competition, the incumbent will predictably have a high market share to start with. Economists have devoted considerable attention to this type of situation and have shown that effective competition can take hold of the market even though the incumbent still retains a relatively high market share.⁴⁵ The aim of any regulatory effort should thus be to bring about effective competition without micro-managing the industry.

Caution is all the more warranted where, as in the postal sector, there is no obvious entry path which would be dictated by economies of scale, network effects or other constraints. In energy or fixed telecommunications, there are few entry strategies, and accordingly regulation can afford to make strong assumptions about entry and in practice accompany entrants along a certain path. Furthermore, the characteristics of these markets (monopolistic bottlenecks in the network or parts thereof) justify such a regulatory intervention. The situation is different in the postal sector. There is no monopolistic bottleneck, and entrants can pursue a number of different and

⁴³ A point made by the Commission in *BdKEP*, *supra*, note 29 at para. 86.

⁴⁴ The new framework is made up of the following directives (i) based on Article 95 EC: Directive 2002/19 of 7 March 2002 (Access Directive) [2002] OJ L 108/7, Directive 2002/20 of 7 March 2002 (Authorization Directive) [2002] OJ L 108/21, Directive 2002/21, *supra*, note 25, Directive 2002/22, *supra*, note 26 and Directive 2002/58 of 12 July 2002 (Privacy Directive) [2002] OJ L 201/37 and (ii) based on Article 86 EC: Directive 2002/77 of 16 September 2002 on competition in the markets for electronic communications networks and services [2002] OJ L 249/21.

⁴⁵ See *supra*, section 2

potentially successful entry strategies. *Regulation should thus carefully avoid pushing the entrants towards a specific entry strategy by favouring one path over the others, as mentioned at the outset of this part.*

In the light of the foregoing, it would be appropriate to follow the test put forward by the Commission when selecting which markets could potentially be regulated, in the context of electronic communications. In its Recommendation on relevant markets in electronic communications, the Commission set out a threefold test.⁴⁶ Pursuant to that test, regulation only comes into question on markets:

- with high and persistent barriers to entry;
- with no prospect of effective competition behind those barriers over time;
- where competition law alone does not suffice to address the problems.

All of these conditions must be fulfilled.

While there is not enough basis to speculate on how markets would be defined, in any event, the results of the study made in Section 2 above show that there are no monopolistic bottlenecks in the postal sector. Accordingly, it is unlikely that the first condition will be met for any market which might be defined in the postal sector. In other words, there would be no obvious candidate for sector-specific regulation.

Even on the assumption that lawmakers and/or regulators would find that regulation of some form of downstream market could be envisaged, at the remedial stage some very important principles must also be respected. These principles are now central to the new framework for the regulation of electronic communications, but they are not new: they correspond to general principles of EC law and as such are equally applicable to the postal sector. They are:

- adequacy: the regulatory remedy must address the problem which was identified;
- proportionality: the regulatory remedy must be likely to remove the problem identified, must not restrict the freedom of firms more than is necessary to achieve its aims and must be in proportion to the problem in question.

These principles are reflected in the structure of the Access Directive for electronic communications,⁴⁷ which provides a range of remedies for regulatory authorities to consider: transparency, non-discrimination, accounting separation, access and price controls. Very importantly, this range increases in intensity, and in line with the principles of adequacy and proportionality, authorities must first look at the lighter remedies and consider the heavier ones only if the lighter ones can be proven insufficient. In this respect, if any regulation were to be envisaged, it appears likely that the non-discrimination obligation already imposed under competition law – coupled if necessary with a transparency obligation in order to render that non-discrimination obligation more easily enforceable – would suffice to ensure a proper functioning of the market.

⁴⁶ Recommendation 2003/311 of 11 February 2003 [2003] OJ L 114/45, Rec. 9. These threefold test is further developed in the Explanatory Memorandum accompanying the Recommendation.

⁴⁷ Directive 2002/19, *supra*, note 44, Art. 9-13.

4. Country Studies

In this section, we examine the situation in a number of selected countries in order to add a practical dimension to the theoretical considerations of the previous sections. Four countries have been selected where some or all end-to-end mail flows have been liberalized, and where the current access regimes vary, namely:⁴⁸

Country	Liberalized end-to-end flows	Share of liberalized market	Access regulation	Market Share of CPOs	CPO share in competitive segment
Germany	Some	33	Yes, avoided costs	5	15
Sweden	All	100	None	8	8
Netherlands	Some	52	None	8	16
UK	Some	30	Negotiations under pressure of cost-based access	0.3	1

For each country, we examine in turn:

- (i) the state of opening of the market;
- (ii) access regulation, now and prospective;
- (iii) the state of competition on the market.

4.1 The German Market

4.1.1 Market Opening

In Germany, the right to provide postal services for correspondence weighing up to 100 grams (and direct mail weighing up to 50 grams) and priced less than three times the rate of a 20 gram letter is reserved for the USP. Germany has adopted a licensing system, with eight types of licenses being distinguished by law, and licenses being given out by RegTP. The most important types of licences are:

- Licence A – conveyance of letter mail items and addressed catalogues outside the reserved areas´ weight and price limits.
- Licence B – conveyance of bulk direct mail weighing more than 50 grams and dispatched in quantities of not less than 50 items.

⁴⁸ The most recent EC progress report, see footnote 1, lists the following market shares of USPs in the letter post market share in liberalized markets in 2003: DE 96.0%, GB 99.7%, NL 95.0%, SE 93.4%. The data in the table are the most recent ones available, they come from a variety of sources mentioned in the text.

- Licence D – provision of postal services, distinct from universal services, having special features and “higher quality”.⁴⁹

The German postal law provides for full market opening by 1 January 2008.

4.1.2 Downstream Access

According to the German postal law, a postal licensee with dominant position (in fact, DPAG) is obliged to give competitors access to portions of its network at rates considered reasonable and competitive by RegTP. RegTP has adopted the principle that the price for access to DPAG’s network should be set at the retail price for the postal service at issue less the cost of services which the USP did not provide. In other words, a “retail-minus” system is in place. As a result, RegTP has required up to 18% percent discount for mail tendered at the USP’s outward sorting center and up to 21% percent discount for mail tendered at the USP’s inward sorting center.

4.1.3 State of Competition on the Market

In the licensed area, the market share of CPOs in terms of revenues was 3.9 % in 2003 and 5.1 % in 2004 (NRA estimate). If these numbers appear small, one should bear in mind that not the entire market is open to competition. In the competition area, that is, the area accessible for competitors, the CPOs market share in terms of revenues was 11.8% in 2003 and 15.1 % in 2004 (NRA estimate), with D licenses accounting for more than half of the letter post volume and about half of revenues.⁵⁰ According to the WIK-report, the average price for delivery of a postal item by a D licensee was about € 0.49 in 2002, while PIN AG, one of the most important D licensees, has opined that there is no demand for still higher quality mail services at higher prices.

PIN AG started its operations in Berlin in 1999; it operates a full-fledged local Berlin area network as of 2001, and has since then further expanded in the areas of Leipzig and Cologne. It focuses mainly, but not exclusively, on business clients and operates a six day a week delivery service. At the end of 2004, Axel Springer and Holzbrink decided to participate in the company, each with a 30% share. The aim of the company is now to grow to a full nationwide network, in cooperation with local partners. At the moment, the company employs about 800 people, revenue in 2003 is said to be around €23.5 million, with the company being profitable since that year. In the local Berlin area, PIN AG is estimated to have a market share around 20%.

Another player on the German market is EP Europost, a joint venture of TNT with the Hermes Logistik Gruppe. In cooperation with some 130 sub-contractors, EP Europost offers a five-day a week delivery of addressed direct mail exceeding 50 grams, catalogues exceeding 100 grams, letters exceeding 100 grams and international mail volumes. It guarantees a nationwide delivery for letters, while other products have coverage of around 70% of all German households.

⁴⁹ The required level of quality is not specified by law, but has been established by RegTP in the course of administrative proceedings and two licence notices (revised edition as of July 2004).

⁵⁰ The WIK report gives the estimated market share of CPOs in 2003 as 4 percent (by revenue) and 3.75 percent (by volume); in 2004, RegTP only provides the share by revenue.

A consolidator on the German market is Direktexpress, a company from Ulm, with revenue of € 31.7 million in 2004.⁵¹ It collects and sorts mail to hand it over for delivery to Deutsche Post. It profits from a discount of 21% of which it claims to give 19% to senders. As of 2005, the company has a capacity to handle 1 million letters per day.

4.2 The Swedish Market

4.2.1 Market Opening

The Swedish postal market was liberalised in 1993. A recent study by the Postal Market Committee,⁵² of which the English language summary can be found on the web site of the National Post and Telecom Agency (PTS), describes the current situation on the market. We here describe some highlights from that study.

4.2.2 Access Regulation

It should be noted that Swedish legislation in the postal sector was initially not adapted to support or create preconditions for competition and that PTS does not play a role in the general promotion of competition in the postal sector. Related to this, the Swedish postal regulation does not provide for mandatory downstream access. In line with EC law, the incumbent is under an obligation not to discriminate among large users and competitors. We refer to Jonsson and Selander (2005)⁵³ for a description of the strategies that the Swedish incumbent used to fight entry.

4.2.3 State of Competition on the Market

The study of the Postal Market Committee describes that Swedish postal market on the basis of the division letters (3269 million items in 2003), unaddressed direct advertising (over 3000 million items) and parcels (some 65 million items). Noteworthy is the fact that, in 2003, 95.8 % of all letters delivered were sent by businesses, hence, households were responsible for only 4.2 % of the volume. Perhaps an explanation for the relatively small share of households can be found in the price development since liberalisation. While the real price for business mail has declined by some 50 % since the early 1990's, the price for overnight delivery of single item mail has increased by 50 percent excluding VAT and by 90 percent including VAT over the period 1993-2003.⁵⁴

In the letter market, the incumbent Posten AB, held 92.9 % of the market in 2003 (3037 million items), CityMail held 6.6 % (216 million items), while the other 26 active postal operators shared the remaining 0.5 % of the market. CityMail has increased its market share from 1.5 % in 1996. Posten AB also has some two thirds of the UDA sub market, as well as a similar share of the parcels market. Jonsson and

⁵¹ Source: Newspaper article "Direktexpress macht Post Konkurrenz", May 3, 2005

⁵² The development of the Swedish postal market - a summary - SOU 2005:5 - January 2005 2005-02-01

⁵³ *Supra* note 19

⁵⁴ The summary of the report does not make clear whether the latter price increase is in real or in nominal terms.

Selander (2005) report the market shares in 2004: Posten still had 92% and CityMail had increased its market share to 7.5%. Noteworthy, however, is the fact that CityMail is estimated to have 25% of the markets in which it has chosen to be active.

The study of the Postal Market Committee concludes: "liberalisation has not meant poorer service or quality regarding nationwide overnight delivery. However, Posten AB continues to have a strong and dominant position on the letter market, particularly regarding individual items of correspondence... A circumstance which may be part of the explanation to the relatively weak development of competition after liberalisation is that there are high barriers to establishment on the sub market individual deliveries, particularly that part referring to overnight nationwide delivery. This means that it is very expensive to build up a parallel nationwide network for delivery of letters." We note that similar statements will apply in all countries. In our view, this need not be a point of concern and does not show a weak development of competition: it only concerns 5% of the market and competitors are not expected to copy the incumbent's business model (5/6 days delivery a week); to the contrary, they will adopt innovative business models for some of which nationwide delivery could make sense.

The committee notes that by lifting the price control on the segment single-item mail, competition might develop in a favourable direction. As households and small businesses only spend small amounts on mail, according to the commission, such a lifting of the price regulation may be justified.

Equally important is the Postal Committee's proposal to boost future competition by imposing "measures against unclear pricing and discrimination". In essence, the Committee aims to further clarify and increase the requirements for non-discrimination imposed on the incumbent, with the postal regulator having the task of monitoring these requirements. Consequently, the Committee believes that increasing transparency would be sufficient to further competition, that imposing access regulation is not necessary. As Jonsson and Selander write:

"In the view of the regulator, this proposed addition will enhance competition by making the incumbent's individual discounts and prices known to the public. An offer from the incumbent of extremely low prices to a single customer would be known to all customers and be attainable for other similar bulk mailings. It is the view of the regulator that the benefits of this transparency are likely to exceed the hardships of determining and cost estimating the standard single piece item, which all discounts should be measured against. The proposed transparency of the incumbent's individual prices and discounts, together with the rules of non-discrimination, will support the supply side of the letter mail market in order to offer prices and discounts of long-term sustainability."

4.3 The Dutch market

4.3.1 Market Opening

In the Netherlands, Directives 97/67 and 2002/39 were implemented with a view to opening up the market as much as possible. Accordingly, the Netherlands made use of the possibilities offered by those directives and left significant parts of the sector –

direct mail and outgoing international mail – open to competition. It is estimated that at the moment some 52 % (in volume) of the Dutch market is open.

The Dutch administration is currently following the evolution of postal regulation in the UK and Germany very closely. It is expected that the Dutch postal market will be completely opened as soon as the UK and Germany do the same and a level playing field is achieved.

4.3.2 Access Regulation

Dutch postal regulation does not provide for mandatory downstream access. As is provided for in European legislation, however (and in line with EC competition law), the incumbent is under an obligation not to discriminate among customers and competitors.

4.3.3 State of Competition on the Market

In 2004, approximately 5.3 billion items of addressed mail were delivered within the Netherlands, 17 million items per working day.⁵⁵ With 7.5 million delivery points, on average, each of these thus point receives 2.27 items of mail per day. The conveyance of letters up to 100 gram is reserved for TNT Post, however, it should be noted that direct mail does not fall in the reserved segment.

TNT Post has two major competitors in the Netherlands. Sandd claims to be the number 2 on the Dutch market, it also states that it made a profit in 2004 and that it will make profits again in 2005. Sandd focuses on end-to-end delivery of bulk mail (direct mail and magazines). In 2004, it distributed 130 million items and had revenues of € 32 million, it expects to grow to 210 million items and to around € 50 million in revenue in 2005. At the moment, it has 90 distribution centers and it uses 6,500 delivery agents, it is growing to 8000 delivery agents in 2005. The company claims to have a market share of 5% of the liberalized market in 2004, and that it will grow to a market share of 8% in 2005.

The second major competitor of TNT Post is Selektmail. It is a joint venture of Deutsche Post and Wegener, a Dutch publishing company. This company is about as large as Sandd. It also operates a nationwide delivery network. In 2004, it employed between 6,000 and 7,000 delivery agents. The company states that in 2003, 2004 and 2005, it made (or will make) a profit, or nearly so, and that it will definitely be profitable in 2007. The company recently revealed that in the first quarter of 2005, it delivered 57 million items, and that it expects to have 8% of the liberalized market in 2005.

Consequently, on the basis of the reports of both these entrants to the Dutch market, it can be expected that at the moment TNT Post would have a share of 84 % of the liberalized segment of the mail market. Three aspects are probably important to explain the success of entrants:

⁵⁵ These data are from the TNT Annual Report (2004) and include letters, direct mail and magazines.

- (i) the market is relatively concentrated on the side of senders, which considerably facilitates entry easy (one can avoid sorting of actual mail by using computerized pre sorting of addresses),
- (ii) the delivery is mostly in urban areas, where economies of scale are less important (one replaces walking by biking, for example),
- (iii) most of the mail, and certainly of the business mail, is not time critical, that is to say it is not that important that the mail is delivered quickly, rather it is important that delivery is taking place on a specific agreed upon day, hence the mail is plannable.

4.4 The United Kingdom Market

4.4.1 Market Opening

At this point in time, the UK postal sector is partially open. Access to the market is essentially conditioned on obtaining a license, of which there are three types:

- a) Bulk mail licenses: for mailings in excess of 4000 items per posting, which can be delivered by the operator itself, or which can be handed over to Royal Mail (RM);
- b) Consolidation licenses: licenses that allow to consolidate mail, hence, to collect mail from a certain number of users and sort it before handing it over to Royal Mail for delivery;
- c) Licenses for certain defined activities.

It is estimated that around 30% (in volume) of the letter market has so far been opened in the UK.⁵⁶ However, we note that *bulk mailers are not allowed to deliver mail from consolidators*. Consequently, competition remains fragmented. Bulk mailers can compete on an end-to-end basis, but they are limited by the definition of "bulk mail". Consolidators, on the other hand, are fully dependent on Royal Mail (RM), to which they must hand over their mail.

In a recent decision, Postcomm decided to speed up the pace of market opening and lift all restrictions on access to the market as of 1 January 2006.⁵⁷ At that point in time, consolidators will, hence, be allowed to hand over mail to bulk mailers.

4.4.2 Access Regulation

Condition 9 of Royal Mail's licence implies that the company is required to enter, in good faith, into negotiations with 'any person' requiring access to its facilities; furthermore access prices must be non-discriminatory, they must be based on a reasonable allocation of costs, and they should take into account Royal Mail's USO obligation. If negotiations fail then Postcomm, the UK regulator for the sector, can be requested to make a determination of the prices and/or conditions that will apply.

⁵⁶ Since 1 April 2002, Postcomm believes 30% by revenue is opened to competition. Phase 2 opening in April 2005 (additional 30% by revenue) was abandoned as a trade off for full opening. page 7-8

⁵⁷ Postcomm, *Giving Customers Choice: A Fully Open Postal Services Market - A decision document* (18 February 2005), available on Postcomm's website.

Postcomm has traditionally been convinced that network access is required for competition to develop and it has accordingly given a lot of attention to access conditions. To this day, Postcomm identifies economies of scale as one of the main barriers to entry on the UK postal market:

"Postcomm's analysis suggests that economies of scale barriers effectively rule out, in the short-to-medium term, a rival nationwide daily delivery network. Operators can help to overcome this barrier if they reduce the unit cost of delivery by adopting a strategy that focuses on reduced delivery services (say once per week) or within restricted geographical areas (such as financial districts)."⁵⁸

In other words, in Postcomm's view, full (nationwide) market entry is not feasible, but it is profitable to enter certain market niches. Postcomm also notes that, because of scale economies, costs are minimized if entrants can access the network of RM, which is consistent with what is stated in Section 2. As a consequence of this, Postcomm has actively pursued a downstream access policy, publishing its first proposals in May 2003. These proposals resulted from Postcomm having been referred a conflict on access between UK Mail (from now UKM) and RM. The points at issue between UKM and RM (with their respective positions) related to:

- the point of access into RM's network (choice between delivery offices (DO) and inward mail centra (IMC), or IMCs only);
- the price (retail-minus or incremental cost);
- the "fall to earth", i.e. whether the mail flows from UKM should match the average flows of RM (no or yes).

In its proposals of May 2003,⁵⁹ Postcomm concluded that RM should offer access at both the IMC and the DO, but with lower prices for DO access to reflect the fact that UKM would then have conducted more of the sorting and distribution process itself. It opted for an access price fixed by reference to incremental costs, plus a contribution to joint costs and a reasonable profit. It also allowed RM to control the "fall to earth" in so-called "revenue protection procedures". Prices had to be geographically uniform.

The Postcomm proposals were never put into effect, however, since RM and UKM voluntarily entered into an access agreement in January 2004.⁶⁰ That agreement was broadly in line with Postcomm's proposal, except that it did not provide for any access at DO level, with Postcomm also expressing reservations about the impact of imposing surcharges for failure to match a certain geographical profile, as this would limit the ability to use other operators without facing surcharges (i.e. could amount to a de facto exclusivity clause).

⁵⁸ See Postcomm, *Competitive Market Review - Consultation Document* (September 2004), available on Postcomm's website, point 27 of the summary. Besides economies of scale, Postcomm also indicates that RM's VAT exemption, its potential anti-competitive behaviour and consumer inertia can lead to barriers to entry. Only economies of scale are a concern here.

⁵⁹ Postcomm, Notice of a Proposed Direction to RM on Downstream Access, by UK Mail, to RM's Postal Facilities (19 May 2003), available on Postcomm's website.

⁶⁰ This part is based on Postcomm's document "Promoting effective competition through downstream access", March 2004.

In April 2004, RM signed a similar agreement with TNT Mail UK, and later with Deutsche Post as well. In October 2004, RM signed another downstream access agreement with a party that was not a licensed operator. As compared to the agreements previously signed, this agreement was based on zonal pricing,⁶¹ hence, the price was not geographically uniform. After the signing of this fourth agreement, UKM and TNT issued a complaint with Postcomm stating that the offer of zonal pricing is in conflict with RM's license conditions. At present Postcomm is investigating this complaint.

In the end, therefore, Postcomm monitors RM's access regime, and it prefers RM to adopt an access code.⁶² Nevertheless, it has indicated its intent to bring RM's access prices under price control and to require RM to implement accounting separation between "core value chain activities". Note that since Postcomm has not firmly committed to a policy, there is regulatory uncertainty that may threaten the business models of entrants: if Postcomm would force low access prices on RM, then access-based entry will be easier, hence, it will threaten the business model of market parties pursuing end-to-end competition.

In its latest set of proposals, published on 1 June,⁶³ Postcom envisages to extend price regulation to the currently available access products of RM. These would be subjected to a retail-minus regime (i.e. the margin between the retail and access products would be regulated), in order to avert a perceived risk of margin squeeze.

4.4.3 State of Competition on the Market

In the words of Postcomm itself in its most recent policy document on the topic:⁶⁴

"Although entry by competitors to Royal Mail has been broad in scope, it has not been particularly "deep" in terms of the volumes handled. The September 2004 proposals showed that competitors operating in the licensed area handled a total volume equivalent to about 0.3% of the regulated market in 2003/04 by revenue. The most recent data suggests this is increasing. During the first three quarters of 2004/5, new entrants carried 0.6% of the licensed market by revenue (or 0.7% by volume)."

In other words, despite the regulatory attention which Postcomm is lavishing on the UK postal sector, the UK is lagging behind in fact.

A few explanations can be put forward for this:

First of all, it could be that the legal framework in the UK is such that the room left for competitors is limited at the moment. With full market opening on 1 January 2006, things might therefore change. Yet a second explanation is that Postcomm is working at cross-purposes to newcomers. With its focus on ensuring access to RM's

⁶¹ For details on the pricing scheme, see Roger Hill and Richard Robinson: "Establishing non-uniform access prices in the UK", paper presented at the 13th Conference on Postal and Delivery Economics, Antwerp, June 1-4, 2005.

⁶² See Postcomm, *Tackling Barriers to Entry in Postal Services – Final Decisions and Recommendations* (31 March 2005), available on Postcomm's website.

⁶³ *Supra*, note 27.

⁶⁴ *Supra*, note 62, para. S.12.

facilities, Postcomm is sending the signal to the market that it prefers an access regime that enables newcomers to ride on RM's facilities ("competition based on access") as opposed to pushing newcomers to set up their own end-to-end operations. Newcomers are therefore shying away from the latter option. In the end, regulatory intervention could become self-sustaining, with Postcomm going further in the prescription of entry strategies. If that explanation is correct, then the situation will not improve as of 1 January 2006.⁶⁵

⁶⁵ Other reasons for the lack of entry could be (a) low RM pricing; (b) the fact that access prices were not known until January 2004, thus making any end to end investment uncertain; (c) political pressure on Postcomm to ensure that RM keeps volumes, thus favouring access.

5. Conclusions and Recommendations

In this report, we have sought to take a fresh look at postal regulation in anticipation of the full opening of the market. We have focussed on the regulation of relationships between competitors, and in particular on access regulation. We have chosen to start from the fundamental questions and avoid the kind of shortcuts which can be observed in some of the literature, whereby the outcome of regulatory processes in similar sectors is simply transposed over to the postal sector.

The starting point must be the economics of the postal sector. On the basis of theoretical considerations and practical evidence, we have seen that neither economies of scale nor economies of scope constitute a barrier to entry. The postal sector is characterized by the absence of monopolistic bottlenecks. Rather, entry in the postal sector is scalable, and here theory and practice concur in showing that a number of different entry strategies are available and potentially successful.

These findings have a number of consequences for the regulatory framework. Here as well, it is crucial to go back to the basics. The removal of the reserved sector changes the function of the regulatory framework completely. A more economic approach to regulation is desirable, with competition law serving as a model and a benchmark. In light of the economic conclusions of the previous paragraph, regulation must avoid prescribing entry strategies and thereby hampering the dynamism and innovative potential of the postal sector. Furthermore, it is important not to let universal service objectives interfere with the design of market regulation: they should only come in at a later stage.

In an open postal sector, it is difficult to predict how competition law would apply. Nevertheless, it is safe to assume, in light of the economic evidence, that competition law (more specifically the essential facilities doctrine) does not warrant forcing incumbents to provide access to their facilities. On the assumption that the incumbent postal operators would be found to hold a dominant position, competition law will apply to as to put them under a non-discrimination obligation.

Transposing these results in the regulatory discussion, this implies that *prima facie* there is no justification for heavy regulatory intervention. This conclusion is strengthened when the analytical framework used to select relevant markets in the electronic communications sector is applied to the postal sector: there appear to be no candidate markets for regulatory intervention. Should there be any intervention, the principles of adequacy and proportionality would also dictate that a light regulatory framework, centred around the non-discrimination obligation arising out of competition law, would be sufficient.

In the end, we must issue a strong recommendation to policymakers and regulators. Take a considerate approach when it comes to postal regulation: this is not just another sector in which regulatory outcomes can be imported by analogy. Rather, if anything can be learned from the experience in other sectors, it is that the policy fundamentals matter. The basic questions – is there any economic justification for regulation? would it not produce more disadvantages than advantages? – must be asked and answered first, before any course of action is taken. This report showed that in an open postal sector, a light regulatory touch is the right answer.

